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No. 87-494

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

DOCUTEL/OLIVETTI CORPORATION, ING. C. OLIVETTI & C., S.p.A., CARLO DEBENEDETTI, EMMETT R. DEMOSS, JR., SIMONE FUBINI, B. J. MEREDITH AND ELSERINO M. PIOL,

Petitioners,

—v.—

HANNAH FINKEL,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITIONERS' BRIEF IN RESPONSE TO RESPONDENT'S CROSS-PETITION

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Question Presented

Should reliance be removed as an element of all causes of action under Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5?

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Petitioners and Cross-Respondents Docutel/Olivetti Corporation ("Docutel"), Ing. C. Olivetti & C., S.p.A. ("Olivetti"), Carlo DeBenedetti, Emmet R. Demoss, Jr., Simone Fubini, B.J. Meredith, and Elserino M. Piol (collectively "Petitioners"), submit this Response to the Cross-Petition for a Writ of Certiorari filed by Mrs. Hannah Finkel (the "Cross-Petition").[1] The issue raised by Mrs. Finkel in the Cross-Petition—the role of reliance in claims under Rule 10b-5(2)—is an important issue and one that has already been raised by the

1 For the list of the corporate Petitioners' parents, subsidiaries and affiliates required by Supreme Court Rule 28.1, see pages 33a-35a of the Appendix to the Petition for Certiorari filed in this Court on August 21, 1987 (the "Appendix"). References herein to "__a" are references to pages in that Appendix.

Petition for Writ of Certiorari (the "Petition").[2] It is thus unnecessary for this Court to grant the Cross-Petition to consider that issue.

If, however, this Court has any concern about its jurisdiction to consider all issues raised by the decision below, then Petitioners respectfully submit that the Cross-Petition should be granted, permitting this Court and the parties to concentrate on substantive rather than procedural issues.

JURISDICTION

The judgment of the Court of Appeals was entered on May 27, 1987 (20a-21a). This Court has jurisdiction to review that judgment by writ of certiorari under 28 U.S.C. §§ 1254(1), 2101(c) (1982). Petitioners timely filed their Petition on August 21, 1987. The Cross-Petition was not filed within 90 days of the judgment. It was filed within 30 days of the Petition, pursuant to Supreme Court Rule 19.5. This Court thus can grant the Cross-Petition only if the Petition is also granted. Sup. Ct. R. 20.5.

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2 Reliance is the link between the decision to purchase or sell securities and the alleged deceptive conduct. It has been referred to as "transaction causation." *See Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 n.24 (5th Cir., Unit A Mar. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983). Transaction causation requires, at a minimum, that the plaintiff knew of the deceptive statement and took it into account in deciding to purchase or sell securities. The "fraud on the market theory," by relying entirely upon market impact ("loss causation"), eliminates transaction causation from claims arising under § 10(b) of the Securities Exchange Act. The theory thus removes any connection between defendants' conduct and the plaintiff's *decision* to purchase or sell securities. This result contravenes congressional intent that *both* transaction causation *and* loss causation are required for claims alleging deceptive conduct. Petition at 11-12.

STATEMENT OF THE CASE[3]

Mrs. Finkel bought 300 shares of Docutel common stock on December 5, 1983. On February 16, 1984, Docutel announced that it projected a $14 million net loss for 1983, $10 million of which was due to a pre-tax inventory write down. On April 2, 1984, *The Wall Street Journal* reported that Docutel had announced that the projected losses for 1983 would be greater than $14 million. Shortly thereafter, Mrs. Finkel filed suit in the Northern District of Texas. She sued Docutel, Olivetti (which owned, through a subsidiary, 46% of the stock of Docutel), and some but not all of Docutel's officers and directors. The complaint alleged violations of § 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission ("SEC") Rule 10b-5 promulgated thereunder.

Mrs. Finkel alleged that Docutel issued three quarterly earnings reports in 1983, before she bought her shares, and that each of those reports "substantially overstated" Docutel's earnings (30a). She alleged that defendants knew, or were reckless in not knowing, that the quarterly reports "contained financial information which was incorrect" (30a).

The complaint alleged that these misstatements inflated the price of Docutel common stock, damaging Mrs. Finkel, who purchased "relying on the integrity of the market" (31a). She did not, however, allege that she knew about any of the three allegedly misleading quarterly reports, let alone considered any of that information in deciding to purchase Docutel stock.

Petitioners moved to dismiss the complaint pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure for failure, *inter alia*, to plead reliance.[4] The District Court dismissed the

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3 Petitioners respectfully refer the Court to the Statement of the Case in their Petition at 3-5.

4 Petitioners also moved to dismiss the complaint under Rule 9(b) of the Federal Rules of Civil Procedure for failure to plead fraud with particularity. The District Court did not rule on that part of Petitioners' motion (18a-19a).

complaint, holding that Mrs. Finkel was required to "allege and prove individual reliance and not merely general reliance" (18a).[5]

Mrs. Finkel appealed the decision. On appeal, the Fifth Circuit held that her claim under Rule 10b-5(2) was properly dismissed because she did not allege that she had read or relied upon any of the SEC filings or newspaper statements allegedly misrepresenting Docutel's financial condition. *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 363 (5th Cir. 1987) (13a-14a). The Fifth Circuit concluded, however, that the complaint pleaded another violation of Rule 10b-5, a "scheme to defraud or course of business operating as a fraud for purposes of the first and third subsections" of the Rule. *Id.* (14a). The court held that claims under Rule 10b-5(1) and (3) did not require proof of reliance. *Id.* (14a).

On August 21, 1987, Petitioners filed the Petition seeking review of the entire judgment. Among other points, Petitioners stated that the Fifth Circuit's decision was in direct conflict with decisions in other circuits that adopted the "fraud on the market theory" even for cases under Rule 10b-5(2). Petition at 15-16.

On September 21, 1987, Mrs. Finkel filed a brief opposing the Petition. She argued that this Court should not grant certiorari because (1) to the extent the Fifth Circuit reinstated the complaint in part, the Fifth Circuit was correct, and (2) to the extent the Fifth Circuit affirmed the District Court's dismissal of the complaint, Petitioners lacked standing to seek review of the decision.[6]

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5 The District Court's order dismissing the complaint, entered on August 20, 1986, is reproduced at pages 18a-19a of the Appendix. The Fifth Circuit's opinion is reproduced at 1a-17a. Respondent's complaint is reproduced at 24a-32a. The full texts of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, are reproduced, respectively, at 22a and 23a.

6 Petitioners filed Petitioners' Reply Brief (the "Reply Brief") in support of their Petition on October 1, 1987.

At the same time, however, Mrs. Finkel also filed the Cross-Petition. She asks this Court to review and reverse that portion of the Fifth Circuit's decision affirming dismissal of her Rule 10b-5(2) claim.[7] She argues that the Fifth Circuit's decision is in conflict with the decisions of other circuit courts of appeals, and with decisions of this Court. Cross-Petition at 8-13. She seeks a ruling that reliance is unnecessary for any claim under Rule 10b-5. *Id.* at 14.

ARGUMENT

The Fifth Circuit's decision rests upon perceived differences in the three sections of Rule 10b-5. The court concluded that the elements of a claim for relief under § 10(b), and Rules 10b-5(1) and (3), do not include reliance, while the elements of a claim under Rule 10b-5(2) do include reliance. Petitioners and Cross-Petitioner *both* agree that this analysis is mistaken. Either § 10(b) requires reliance, or it does not.

The Petition and Cross-Petition thus present, from differing points of view, the same question: should the reliance requirement be abolished in claims arising under § 10(b)? Because the Petition and the Cross-Petition both raise the same fundamental issue there is no apparent need for this Court to grant the Cross-Petition. All issues will be addressed in connection with the Petition. However, if this Court believes that there is any question about its jurisdiction to consider all the issues raised by the opinion below, Petitioners respectfully submit that this Court should grant the Cross-Petition.

I. THE PETITION PROPERLY RAISES FOR REVIEW ALL THE ISSUES CONSIDERED BY THE COURT BELOW; THE CROSS-PETITION IS UNNECESSARY

The Cross-Petition suggests two reasons why this Court should grant certiorari: (1) the decision dismissing the claims under Rule 10b-5(2) for failure to plead reliance was wrongly

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7 Petitioners initially waived their right to respond to the Cross-Petition. This Response is being filed pursuant to a request of the Court.

decided and should be reversed; and (2) the decision below conflicts with decisions of other circuit courts and this Court, and reflects confusion that should be corrected. Both issues are already properly before this Court, albeit with a different perspective, in the Petition.

As to the first question, the Petition and Cross-Petition present two viewpoints on the same issue: the need for reliance in claims under § 10(b). Petitioners contend that reliance is a necessary part of *any* claim under § 10(b), and is thus a necessary part of a claim under Rule 10b-5(2). Petition at 7-15. Cross-Petitioner argues that reliance should be unnecessary for any claim brought under § 10(b), no matter what section of Rule 10b-5 is pleaded. Cross-Petition at 6-9, 13-14.

As to the second ground, the Cross-Petition correctly points out that there is a direct conflict among the circuits on the issue of reliance and the "fraud on the market theory." That issue, as well, has been raised by the Petition. Petition at 15-16.

Thus, because the Petition properly seeks review of all aspects of the Fifth Circuit's judgment there is no need to grant the Cross-Petition. *See* 28 U.S.C. § 1254(1) (1982) (review by writ of certiorari granted upon the petition of "any party"). *See also Director, Office of Workers' Compensation Programs v. Perini North River Associates*, 459 U.S. 297, 304-05 & n.13 (1983) (Department of Labor official permitted to petition for review of a decision of a board of his own agency; constitutional requirements satisfied by respondent being adverse to petitioner); *United States v. Nixon*, 418 U.S. 683, 686-87 & n.2 (1974) (successful party in district court sought, and obtained, review of district court decision on writ of certiorari after unsuccessful party had appealed to court of appeals but before court of appeals rendered a decision); *Langnes v. Green*, 282 U.S. 531, 538 (1931) (Supreme Court has power to review a respondent's objections to the court of appeal's decision even if no cross-petition was filed); R. Stern, E. Gressman & S. Shapiro, *Supreme Court Practice*, § 2.4 at 46 (6th ed. 1986) ("The literal language of the § 1254(1) reference

to 'any party' is broad enough to encompass the successful or winning party before the court of appeals").

II. THE FIFTH CIRCUIT'S DECISION REQUIRING RELIANCE CORRECTLY APPLIED WELL-ESTABLISHED PRECEDENT, BUT THE USE OF RULE 10b-5(1) AND (3) TO ABOLISH THE RELIANCE REQUIREMENT WAS IMPROPER AND SHOULD BE REVIEWED AND REVERSED

A decision about the need for reliance and the validity of the "fraud on the market theory" must turn upon Congress' intent in enacting § 10(b). That intent cannot be altered by an SEC rule so as to require reliance for some claims and excuse reliance for others. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), this Court stated:

> More importantly, Rule 10b-5 was adopted pursuant to authority granted the Commission under § 10(b). The rulemaking power granted to an administrative agency charged with the administration of a federal statue is not the power to make law. . . . Thus, despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10(b).

Id. at 213-14.

In *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), this Court stated that the language of Rule 10b-5 could not change the scope of § 10(b). A complaint "states a cause of action under *any part of Rule 10b-5* only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute." *Id.* at 473-74 (emphasis added). "Manipulative" conduct is not at issue here.[8] This is a claim for damages caused by inflation of the price of a security through mislead-

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8 "The term [manipulation] refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Santa Fe*, 430 U.S. at 476.

ing statements. Such claims are for "deceptive" conduct. Because reliance is, and always has been, a central element of a claim for deception, reliance is an element of such a claim under § 10(b). Petition at 7-12; Reply Brief at 3-4.

A. The Decision Requiring Reliance Properly Applied Well-Established And Easily-Applied Precedent

The Fifth Circuit's initial analysis of the reliance requirement, as applied to this action, was a simple application of long-established precedent. In *Huddleston v. Herman & MacLean*, 640 F.2d 534, 548 (5th Cir., Unit A Mar. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983), the Fifth Circuit correctly stated that reliance is an element in *all* actions under § 10(b).

The Fifth Circuit in *Huddleston* noted that the "presumption" of reliance set forth in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), applied only to situations where nothing was said, where the defendant stood "mute" in the face of a duty to disclose. *Huddleston*, 640 F.2d at 548. Thus, deceit by half-truth, by leaving a crucial piece of information out of an affirmative statement, is not an "omissions" case, entitled to a presumption of reliance. It is a case of positive misrepresentation. Such a case requires reliance upon the specific misleading statement.[9]

The principles in *Huddleston* apply directly to this action. Docutel did not "stand mute" about the value of its inventory or its earnings. It repeatedly made public statements about that

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9 The distinction between misrepresentations and omissions is neither "gossamer fine" nor "semantic", as the Cross-Petition asserts, but a valid one that has been recognized by this Court. *See Affiliated Ute*, 406 U.S. at 152-53. *See also Kirkpatrick v. J.C. Bradford & Co.*, 827 F.2d 718, 722 (11th Cir. 1987); *Huddleston v. Herman & MacLean*, 640 F.2d at 548. This distinction, moreover, is one that can be made on the face of a pleading. Mrs. Finkel's complaint, for example, alleges overstatement of inventories and net profits and understatement of net losses and cost of revenues. That is clearly a cause of action based upon misstatements, not omissions (30a-31a).

financial information. Those statements were published in *The Wall Street Journal*. That information was contained in documents filed with the SEC. The complaint alleges that those statements were false, that the value of the inventories was lower (30a-31a). To call this an "omissions" case is to call *every* case an omissions case when the defendants omit to state that the statement is untrue.

Mrs. Finkel suggests that requiring reliance in § 10(b) claims violates this Court's decisions. As shown in Petitioners' Reply Brief, that is incorrect. Reply Brief at 5-6. Indeed, the primary case she cites, *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970), was an omissions case challenging a proxy as defective under § 14, 15 U.S.C. 78n. Moreover, Mrs. Finkel admits that this Court has never ruled on the "fraud on the market theory." Cross-Petition at 11.

B. The Fifth Circuit Erred In Distinguishing Among The Sections Of Rule 10b-5 With Respect To The Reliance Requirement; That Decision Should Be Reviewed And Reversed

The Fifth Circuit erred in concluding that reliance could be dispensed with if a claim could be characterized as falling within the language of sections (1) or (3) of Rule 10b-5. The Cross-Petition is correct that the distinction between Rule 10b-5(1) and (3) and Rule 10b-5(2) made by the Fifth Circuit is mistaken and should be reviewed. There is no practical difference between the claim that was dismissed for lack of reliance and the claim that was upheld. The Fifth Circuit, by a bit of linguistic sleight of hand, managed to simultaneously dismiss and uphold the same claim for relief.

The Fifth Circuit purported to reach this result from the language of Rules 10b-5(1) and (3):

> [P]laintiff's complaint, taken as a whole, alleges that Olivetti forced Docutel to take its worthless inventories, that this scheme or course of business was not disclosed,

> and that the effect was to defraud certain purchasers of Docutel.
>
> * * *
>
> The most significant event which allegedly led to the loss by plaintiff is the claim that Olivetti forced Docutel to take worthless inventories without disclosing that fact in the market place; if proved, that conduct could equate with a scheme to defraud or course of business operating as a fraud in violation of 10b-5(1) and (3).

817 F.2d at 363-64 (14a-15a). Thus, if a plaintiff alleges merely a series of misrepresentations and half-truths, the Fifth Circuit will require reliance. But, if a plaintiff alleges that a series of misrepresentations and half-truths was really a "scheme to defraud," then reliance is unnecessary. There is no basis in the Rule, or more importantly, in the statute, for this distinction.[10]

The Fifth Circuit's use of sections (1) and (3) of Rule 10b-5 to abolish the reliance requirement of § 10(b) should be rejected. This Court should grant the Petition, and hold that § 10(b) requires reliance in all cases alleging deceptive conduct.

III. THE FIFTH CIRCUIT'S DECISION IS IN DIRECT CONFLICT WITH DECISIONS OF OTHER CIRCUIT COURTS OF APPEALS

The Cross-Petition correctly states that the judgment below conflicts with decisions of other courts of appeals. Cross-

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10 Olivetti did not engage in a scheme to force worthless inventory on Docutel. Nor did plaintiff try to plead such a claim. *See* 24a-32a. Had she done so, her complaint would have been defective under *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), which held that § 10(b) does not deal with claims of corporate mismanagement or breach of fiduciary duty. 430 U.S. at 477-80. Plaintiffs cannot bootstrap such state law claims into federal securities laws violations by alleging failure to disclose breach of duties imposed under state law. *Gaines v. Haughton*, 645 F.2d 761, 779 & n.33 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 288-89 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Massaro v. Vernitron Corp.*, 559 F. Supp. 1068, 1079 (D. Mass. 1983). *See also* Petition at 18-19.

Petition at 8-11. That conflict was already raised by the Petition, however. Petition at 15-16. But irrespective of how this Court chooses to address the issue, Petitioners agree that the conflict should be resolved.

The conflict is clear and substantial. The Fifth Circuit held that, in the case of securities traded on the open market, a complaint based upon Rule 10b-5(2) must allege individual reliance. 817 F.2d at 362-63 (12a-14a).[11] That holding directly contradicts two other circuit courts of appeals that have held, in the case of securities traded on the open market, that a plaintiff need not plead and prove reliance regardless of whether the complaint alleges a violation of Rule 10b-5(2) or another section of that Rule. *Peil v. Speiser*, 806 F.2d 1154, 1162-63 (3d Cir. 1986); *Lipton v. Documation, Inc.*, 734 F.2d 740, 747 & n.11 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985).[12]

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11 The Fifth Circuit does not "stand alone" in rejecting the applicability of the "fraud on the market theory" to Rule 10b-5(2) cases. The Court of Appeals for the Eleventh Circuit recently held that in certain cases individual reliance is still an element of a Rule 10b-5(2) action, although "fraud on the market" can substitute for reliance in a Rule 10b-5(1) or (3) action. *Kirkpatrick v. J.C. Bradford & Co.*, 827 F.2d 718, 724 (11th Cir. 1987). *Kirkpatrick*, which was decided after the Petition was filed, creates a distinction in the Eleventh Circuit between cases involving newly-issued securities and those involving securities traded on the open market. As *Kirkpatrick* acknowledged, *id.* at 722, the Eleventh Circuit has adopted the "fraud on the market theory" for cases involving stock traded on the open market. *Lipton v. Documation, Inc.*, 734 F.2d 740, 747 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985).

12 The Fifth Circuit's decision also conflicts with *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). The Ninth Circuit did not address the purported distinctions among the various sections, but it did adopt the "fraud on the market theory" in a Rule 10b-5 case where the "gravamen of all the claims [was] the misrepresentation by reason of annual and interim reports, press releases and SEC filings of the financial condition of Ampex. . . ." *Id.* at 894. Thus, a claim alleging misrepresentations would require reliance in the Fifth Circuit, but not in the Ninth.

CONCLUSION

For all the foregoing reasons and for the reasons set forth in the Petition and Petitioners' Reply Brief, the Petition for Writ of Certiorari should be granted. Should this Court conclude that granting the Cross-Petition as well would remove any jurisdictional questions, then Petitioners support the granting of the Cross-Petition.

Dated: New York, New York
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